COMMENT

The evolution of M&A insurance

In this article, **Dean Andrews** looks at the origin and development of M&A insurance to facilitate transactions – and where it might go next

WHERE IT ALL STARTED

It was the mid-1990s. John McClane was about to Die Hard with a Vengeance and the Nokia 232 was the latest must-have gadget. More importantly, this was when requests to help with the transfer of risk in mergers and acquisitions (M&A) started to land on the desks of Financial Lines brokers.

Directors who were standing behind warranties in a share purchase agreement (SPA) for the disposal of a business were looking to their Directors & Officer's (D&O) insurance policies for cover if a claim was brought against them. Insurers were not prepared to provide cover for the specialist risk in a D&O policy and so Warranty & Indemnity (W&I) insurance was born. Although insurance for contingent litigation and tax risks had been around for some time, it was their nexus to W&I which entrenched M&A insurance as a new offering.

W&I was originally used by sellers as a way for them to release the capital they would otherwise have had to ringfence for up to seven years after a deal closed. There was an increase in its use following the financial crash of 2008 as there was significant reduction in companies' appetite to retain risk.

While sellers and banks sought unencumbered receipt of disposal proceeds, buyers wanted a counterparty with a credible balance sheet to claim against if necessary. This is when W&I insurance really started to take root and its value as a deal-facilitation tool was recognised.

TODAY'S GLOBAL M&A INSURANCE MARKET

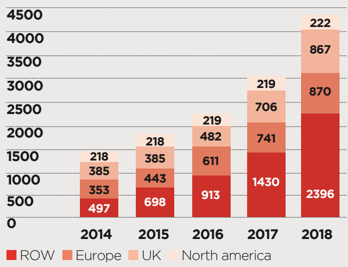
A conservative estimate puts the amount of capacity placed in the global W&I insurance market in 2018 at £90bn.

£90b

Amount of capacity placed in the global M&A Insurance market in 2018

There were approximately 1,100 W&I policies written globally in 2014, rising to 4,500 in 2018, with approximately £2bn of capacity available for a single transaction.

Transactions utilising M&A Insurance in that last 5 years



There are now more than 45 M&A insurance platforms globally and hundreds of dedicated underwriters and brokers.

Cover is broader and rates have plummeted as more competition has entered the market. Five years ago, rates for UK transactions were typically 1.5% -1.75%, while now they are often less than 1%.

THE ROLE OF PRIVATE EQUITY

So, what was the key driver behind the dramatic increase in the use of W&I cover in a relatively short period?

Primarily, private equity (PE). PE's requirement for a 'clean exit' on disposals often led to difficult negotiations as this was countered by a buyer's need for recourse in the event of a warranty or indemnity breach.

Once PE embraced W&I insurance, its use increased exponentially both in the UK and the US. PE sellers used 'buy-side' W&I to transfer risk to buyers by reducing the financial cap in the SPA (commonly £1 today).

This meant that buyers could only claim against the seller up to the financial cap and were on the hook for any losses below their excess, as well as any excluded by their policy.

This approach – where we have seen a significant transfer of risk from sellers to buyers – has become the norm and today, 95% of W&I policies placed are buy-side.

IMPACT OF W&I ON DEAL DYNAMICS

A key requirement of insurers is that the deal is negotiated as if there is no insurance being used. The rationale for this is that risk is allocated on a commercial basis, with the insurer taking on no more risk than the seller would otherwise have taken on.

THE REALITY IS THAT THE USE OF INSURANCE HAS BECOME PART OF, AND SHAPED, THE M&A PROCESS.

It has had an impact in two key areas:

Due diligence – although there was an attempt to reduce the scope of buyer's due diligence required when there is a W&I policy in place, as W&I has evolved this has gone the other way. Buyers of W&I appreciate that there needs to be sufficiently robust due diligence to satisfy the insurers, which may go beyond what they would have sought had there been no insurance. However, insurers are also pragmatic about the level of due diligence they expect.

Arm's length negotiations – the introduction of '£1 cap' policies drastically reduced the seller's motivation to incur the costs of negotiating documents and carrying out a disclosure exercise on an arm's length basis. However, underwriters recognise what commercially negotiated documents look like so, again, this was not a position the market accepted and is not the basis on which transactions are generally insured.

LOOKING AHEAD

Possible developments in the M&A insurance market include the following:

A downturn in the M&A market increases the negotiating position of buyers, who require the sellers to stand behind meaningful finance caps, potentially resulting in a slight increase in sell-side policies being used. Premiums continue the downward trend in the immediate term as new entrants continue to join the market.

Cover continues to broaden as underwriting styles change to adapt to a service-led model.

Claims rise, leading to a hardening market in the medium term as new entrants cease, some insurers pull out and capacity providers shift their capital to the better-performing MGAs.

An increase in flexibility of contingent risk policies. Tailor-made policies to cover tax, environmental, litigation and intellectual property risks become more prevalent.

The use of artificial intelligence (AI) in underwriting becomes more commonplace. Some insurance platforms have already integrated AI into how they profile transactions, which we expect to become the norm as investment in this area increases.

Paragon International Insurance Brokers is a specialist in M&A insurance.

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